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**Managing Director & Principal**

June 1, 2011

Dr. Louis Moret  
Chair, Performance and Compensation Committee  
California Public Employees' Retirement System  
400 Q Street  
Sacramento, CA 95814

Re: Fiscal 2012 Incentive Compensation Worksheets

Dear Dr. Moret:

You requested Wilshire's opinion with respect to the proposed revised incentive compensation worksheets for Portfolio Managers and higher for fiscal year 2012.

### **Recommendation**

**Wilshire recommends that the Performance and Compensation Committee approve the second reading for the worksheets as proposed for Staff.**

**While we do recommend adoption of the benchmark proposed for the AIM asset class, we have specific comments regarding the use of the benchmark below.**

### **Discussion**

Wilshire has reviewed the worksheets proposed by Staff for fiscal year 2012 and recommends that the Committee approve the worksheets for second reading. During the course of the creation and editing of these worksheets, Wilshire has made a few dozen comments to Staff regarding recommendations and corrections. All of the issues we have raised with Staff have been successfully resolved to date. This latest batch of worksheet revisions includes the final details regarding the AIM worksheets and Global Equity asset class measure that were pending finalization at the time of our last letter.

We note that the study last year by an outside consultant recommended "increasing consistency" among the worksheets for all personnel. In the worksheets proposed for next fiscal year, there have been a number of changes that have both increased and decreased consistency among the various asset classes. Where consistency has decreased, HR Staff has reviewed the proposed changes with investment Staff and has presented arguments for why these changes are in the best interest of the system. As much as uniform consistency is a desirable goal, the realities of the actual duties and projects being undertaken by Staff dictate that this goal may be unobtainable in the near term.

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Generally speaking, the Total Fund and Asset Classes weights are highly or perfectly consistent across all asset classes at common levels (i.e., an SPM in Fixed Income has the same Total Fund and asset class weightings as does an SPM in any other asset class). The inconsistencies that remain are for subjects such as the proportion of quantitative versus qualitative factors among some asset classes, the heavy reliance of measures other than portfolio performance for Real Estate, and the value-added targets for AIM as a proportion of total asset class volatility versus other asset classes.

### **AIM Benchmark Comments**

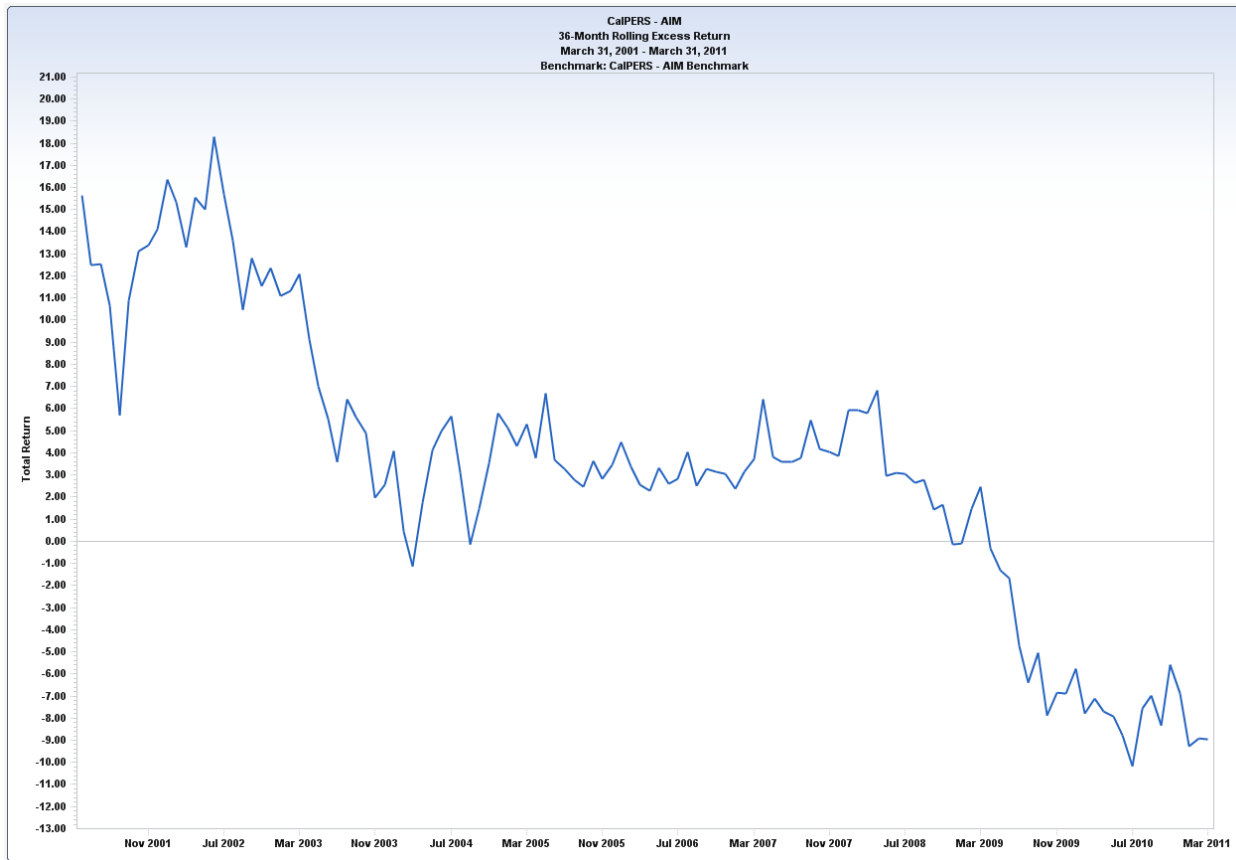
We note that the new incentive compensation worksheets have changed the measure of AIM performance from a universe comparison to a “public equities plus 300 basis points” index. This is the second change to the AIM benchmark in the last few years, as AIM previously used a custom-created private equity “young funds” index.

In concept, we support the use of this benchmark, since the public equities-based index has been used as the component of the Total Fund composite benchmark for the last several years. This change aligns the performance goal of the AIM program with the Total Fund.

However, as we note in the charts below, the relative performance of the AIM portfolio versus an AIM benchmark has not been the same as relative performance versus a public markets benchmark. Over the last 11 years, there have been six years in which the AIM portfolio has outperformed or underperformed the broad universe of private equity managers on a medium-term basis, yet has had the opposite performance versus the public equity benchmark. If history is any guide, we expect that this change in benchmark will lead to performance bonuses during some periods when Staff underperforms their private equity peers and no bonuses during some periods when they outperform.

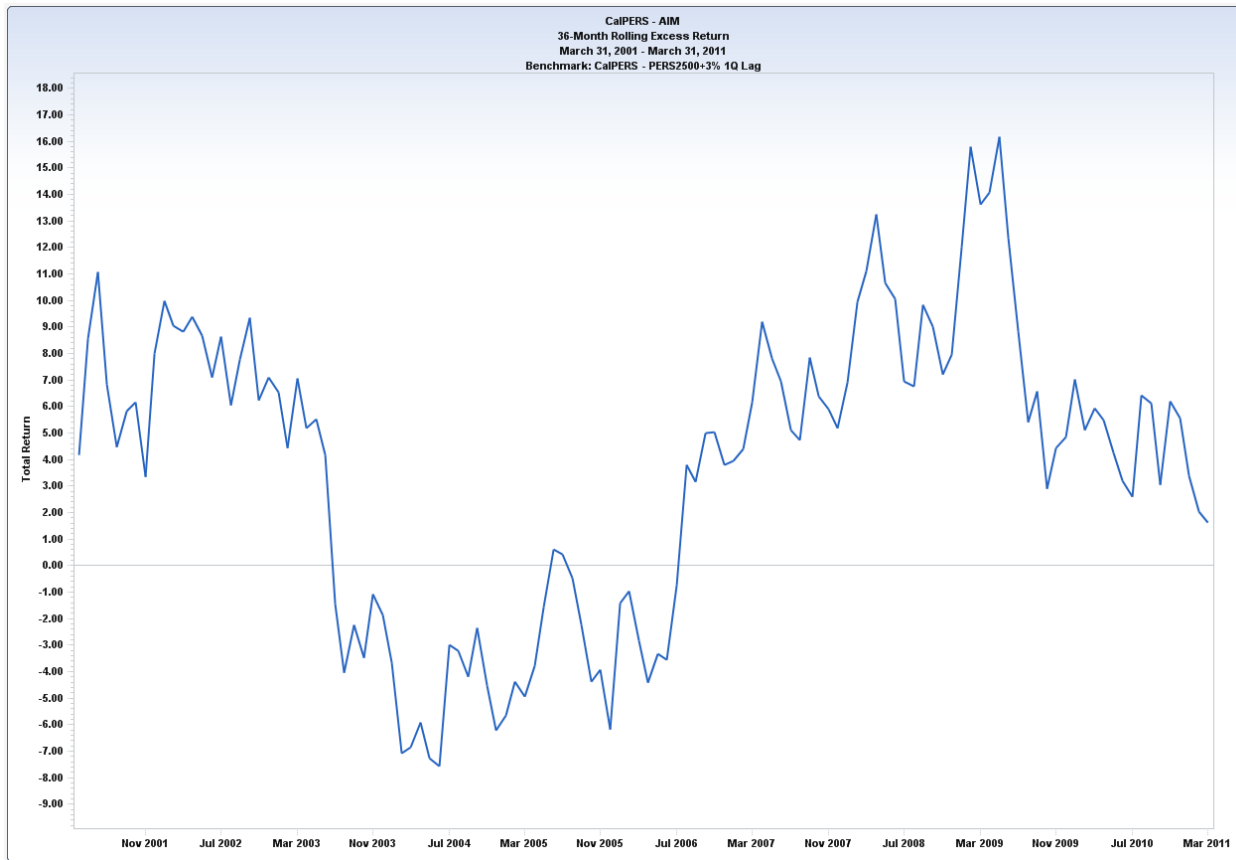
Staff has been made aware of this issue and they say that they are prepared to live with the consequences of this change.

The first graph, below, shows that the AIM portfolio generally outperformed the AIM benchmark (granted, it was the very imperfect “Custom Young Funds” benchmark) from (at least) 2000 to 2009 on a rolling three-year basis.



In the next graph, below, we can see that the AIM portfolio underperformed the US equity benchmark plus 300 basis points from 2003 to 2006 on a rolling three-year basis.

Combining the results from these two charts, we can conclude that had Staff's incentive compensation been based on a stock benchmark for the entire period, Staff would have been paid no incentive compensation bonuses from 2003 to 2006, despite outperforming the Private Equity index by 3% to 5%. Conversely, AIM has underperformed the private equity benchmark by up to 10% since 2009 yet would have received full bonuses during this period.



Please let us know if you have any questions or comments.

Best regards,

A handwritten signature in black ink, appearing to read 'Michael A. ...'.